A COMPARISON OF TREATMENTS ACCORDED RESERVES BY SELECTED ACCOUNTING AUTHORITIES

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A THESIS

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BY

JESSE BENJAMIN BLAYTON, JR.

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CHAPTER I

INTRODUCTION

Basic Accounting Considerations

Before any attempt to investigate the accounting treatment of reserves, it is suggested that the basic nature of accounting be reviewed. While defying exact definition, accounting may be identified by its two major functions: to record and classify events which are of a financial character; and to analyze, summarize, and interpret financial records.[1]

The principal statements in which the accountant illustrates his findings are the balance sheet and the income statement. The first is a statement designed to show financial condition. The second is a report of activity. They are complementary and should be viewed as a unit.[2] Though appearing to present a picture of exactitude and finality, the statements are limited in their degrees of accuracy. They are limited because they are essentially interim reports, based on the concepts of the going concern and the business entity, presented in terms of a fluctuating unit of value which is incapable of expressing factors that cannot be measured in terms of the monetary unit.[3]

A majority of the terms which are included in the accounting vocabulary

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1 Edward G. Nelson, "A Brief Study of Balance Sheets," The Accounting Review, XXII (October, 1947), 341.

2 W. A. Paton (ed.), Accountants Handbook (New York, 1944), pp. 3-4.

3 Ibid., p. 33.

are also in common use, frequently with entirely different meanings attached to them. This fact has contributed to a considerable degree of misunderstanding with respect to financial statements among interested parties.[1] An interesting observation follows:

> Although accounting employs the familiar language in which all of our thoughts are expressed, it is like the language of contract bidding - conventions have given special significance to words and phrases. The accountant who prepares the reports and the laymen to whom they are addressed too frequently are in the regrettable position of bridge partners of whom only one fully understands the language of the activity in which they are engaged.
>
> Any language to be fully useful, must be understood by both the speaker and the listener, by the writer and the reader. Unfortunately, this is not always the case with accounting. Business executives too often are unable to read their accounts and are not always able wholly to grasp the significance of the reports prepared for their guidance in making managerial decisions; professional men frequently are handicapped in their service to clients by their unfamiliarity with accounts: and many investors cannot adequately analyze the reports of companies in which they have placed their funds or contemplate placing them.[2]

The confusion surrounding accounting terminology goes even further. "Even among accountants some terms e.g., income, earnings, surplus, reserve, fixed assets, funded debt, have no single meaning."[3] Attempts are continually being made to alleviate this problem through use of descriptive terms and qualifying phrases.[4] It should be borne in mind, however, that

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1 Ibid., p. 10.

2 H. A. Finney, General Accounting (New York, 1946), p. 5.

3 W. A. Paton, op. cit., p. 11.

4 Ibid.

words in themselves mean nothing. It is only when a thinker makes use of them that they have meaning.[1]

Standardization of accounting principles and procedures has enjoyed only limited success. In the types of enterprise subject to regulatory supervision by established agencies, uniformity of practice has been the trend if not the requirement.[2] While standardization is to be desired it should not be pursued in a dogmatic fashion. Accounting has been described as a "tool" of business, but it is more than a "tool"; it is a whole set of "tools" designed to serve different functions in different situations. Techniques are flexible, not rigid, and should be shaped to meet a variety of uses; thus the form and content of financial statements should vary with the uses for which they are prepared.[3]

> Standardization and rigidity are greatly to be desired, if for no other reason than to facilitate understanding; yet accounting reports are narratives and, like the story teller, the accountant must frequently adapt his presentation to his audience and adjust the content of his tale to emphasize his point.[4]

Conventional procedures and classifications at times tend to present a picture of static elements. Changes in procedure, as accounting continues in its state of flux to keep abreast of changes in business practices, are not always accompanied by changes in terminology and presentation. Because

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1 Edward G. Nelson, op. cit., p. 341.

2 W. A. Paton, op. cit., pp. 16-29.

3 Edward G. Nelson, op. cit., p. 342.

4 Ibid.

of this, students, laymen and even accountants frequently make the mistake of assuming the elements of an accounting statement to be static. It should be understood that though accounting has developed certain conventional methods and customary forms for presentation of data, the methods and forms should be used wisely and never at the expense of judgement.[1] Accounting rules or practices should be used only so long as they give satisfactory results. If other rules or practices are found to yield better results, there is nothing in the nature of accounting to prohibit their adoption.[2]

Reserves: Terminology, Classification, and Mechanics

In general usage "reserve" has the meaning of withholding for the present in anticipation of possible future use. The accountant has not consistently used this word in such a manner; but when he has used it in the title of accounts, he has given it only to accounts which normally have credit balances.[3] In accounting terminology the term "reserve" has had many applications. Its varied usage has contributed to confusion in the interpretation of corporate financial statements.[4] Due to the prominence of "reserve" items in balance sheets, and the effect upon apparent earnings of the methods used in their derivation and retirement, they merit and must receive careful scrutiny if the true picture of a firm's financial condition

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1 Ibid.

2 Thomas H. Sanders, "Progress in Development of Basic Concepts," Contemporary Accounting, ed. Thomas W. Leland (New York, 1945), Chap. i, p.2.

3 Louis O. Foster, Introduction to Accounting (Chicago, 1942), p. 468.

4 H. A. Finney, op. cit., p. 339.

is desired.[1]

In accounting usage "reserves" are frequently placed in three basic categories; valuation, liability, and surplus.[2] Other "reserves" possessing elements of a combination of these are generally referred to as "mixed". The reserve types may be distinguished in accordance with methods of derivation, purposes of creation, periods involved, and balance sheet presentation.

Valuation Reserves, referred to by some authorities as operating or contra - asset reserves,[3] are created by charges to operations to adjust downward asset valuations in accordance with expirations of costs or changes in market price which have already occurred. They are deducted from their related assets.[4]

Liability Reserves are created by charges to operations to record accruals of estimated expenses already incurred, and are carried in the liability section of the balance sheet under the most appropriate subheading in accordance with their maturity.[5]

Surplus Reserves are created by transfers from earned surplus to segregate portions of earned surplus which have been earmarked for future use

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[1] Perry Mason, Fundamentals of Accounting (New York, 1942), p. 382.

[2] Raymond W. Coleman, Elements of Accounting (New York, 1941), p. 173.

[3] Perry Mason, op. cit., p. 382.

[4] Eric L. Kohler, "Surplus," Contemporary Accounting, ed. Thomas W. Leland (New York, 1945), Chap. iv, p. 8.

[5] Ibid.

upon the occurence of specific events.[1] Their effect is to decrease the earned surplus available for dividends and to retain in the business assets in the amount of the reserves set up. They are properly presented as subdivisions of earned surplus in the net worth section of a corporate balance sheet.[2]

Mixed Reserves possess a general character that is so heterogeneous that a definition is difficult if not impossible. All are created through charges to operations. Kohler, in his attempt to describe them, presents the following discussion.

> Mixed Reserves: any combination of the above examples [valuation, liability, and surplus reserves] may be found in contingency reserves against which expenses or losses have been or are subsequently to be charged, or deferred-maintenance or postwar and similar reserves which are created by charges against current income and which will be ultimate repositories of various types of future costs not yet known. Another name applied to this sort of reserve, especially where its purpose is to smooth out operating results as between years, is "equalization" reserve.[3]

There has been increasing opposition to the indiscriminate use of the term "reserve". Several authors feel that its use should be limited to the classifications presented in the preceding paragraphs. Others feel that the term should be further restricted to indicate only allocations of surplus

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[1] Earned surplus consists of the excess of past profits over losses and dividends. It may be subdivided as appropriated (restricted) surplus and unappropriated (unrestricted) surplus. Restrictions on earned surplus may be either legal, i.e., arising out of contract, or voluntary, representing the adoption of a definite policy with regard to surplus. Roy B. Kester, Principles of Accounting (New York, 1939), p. 455; James O. McKinsey, Accounting Principles, revised by Howard S. Noble (Cincinnati,1939), p. 482.

[2] Eric L. Kohler (ed.), op. cit.

[3] Ibid.

or contingency reserves arising from charges to operating expense.[1] One author goes so far as to suggest that the term "reserve" be applied only to appropriations of earned surplus.[2]

Another approach is to limit the meaning of "reserves" to those items which place restrictions on earned surplus, either directly or through operations, to provide for future possible losses.[3] This system eliminates valuation and liability reserves as previously defined. It also eliminates from the surplus category those appropriations which are designed to provide for permanent capital or liquidation of liabilities.[4] This leaves two types of accounts which are designated as "reserves". They are reservations of profits and reservations of surplus to provide for possible losses. Under this system the terms "Operating Reserves" and "Earned Surplus Reserves" are used to identify the respective types.

> Operating Reserves are those arising out of charges to current operations, whether normal or extraordinary, and represent reservations of profits to provide for possible future losses [including both costs and expenses], either decreases in assets or increases in liabilities.
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> Earned Surplus Reserves are those created out of earned surplus,

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[1] Arthur Warren Hanson, Auditing Theory and its Application (New York, 1942), p. 113; Maurice H. Stans, "Weakness in Financial Reporting Caused by Improper Use of Reserves," The Journal of Accountancy, LXXXV, p. 191.

[2] Robert H. Montgomery, Auditing Theory and Practice (New York, [1940]), p. 374.

[3] Charles H. Langer, Accounting Principles and Procedure: Advanced Accounting (Chicago, [1946]), I, 249.

[4] Langer suggests that accounts be termed as "valuation accounts instead of "valuation reserves"; "accrued liabilities" instead of "liability reserves"; and "earned surplus appropriations" instead of "surplus reserves", when such segregations of surplus are for capital purposes and not to provide for future possible losses. Op. cit., pp. 249, 250, 256a.

> and represent reservations of earned surplus to provide for possible future losses, either decreases in assets or increases in liabilities.[1]

The distinction is supported with the argument that although both reserves are reservations of profits, as the profits of one fiscal period becomes a part of the surplus of the next, joint classification could result in an incorrect statement of operations for a given period.

It should be noted that no mention is made of capital surplus, donated surplus, paid-in surplus, or appreciation surplus as sources for the creation of reserves under any of the systems which have been outlined. The fact that in certain instances these surpluses are available for dividends would seem to indicate that in such cases they could be utilized as sources for certain reserves. This is not true. Any reserve created from such a base would result in an overstatement of earned surplus. Regardless of the method of classification used most "reserves" are properly created only through charges to operations or charges to earned surplus.[2] Some authorities take exception to this rule.[3]

A peculiar type of "reserve" in favor with some accountants, is the "Reserve for Unrealized Increment", variously referred to as "Reserve for Unrealized Profits", and "Reserve for Book Value of Assets over Cost".[4] Such a reserve is in fact appreciation (or revaluation) surplus.[5] This reserve

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[1] *Ibid.*, p. 249.

[2] *Ibid.*, p. 252.

[3] H. A. Finney, *op. cit.*, p. 341.

[4] *Ibid.*, p. 346.

[5] Charles H. Langer, *op. cit.*, p. 256a.

type is created when it is desired to show fixed assets at appraisal values in excess of cost less depreciation, assuming adequate depreciation charges in the past. It is created by a charge (s) to the asset (s) in question with a corresponding credit to the "reserve". The "reserve" must be shown on the right side of the balance sheet, preferably in the net worth section, as the net worth has increased in the amount of the increase in asset valuation.[1] Opposition to the use of such classification prefers the term "Appreciation Surplus" to "Reserve for Unrealized Increment". In either case the account is best presented as an independent section of net worth.[2]

Scope of Study

It is to be noted that no mention was made of life insurance reserves, bank reserves or secret reserves in the preceding section. The first two will be disposed of here, the last will find its proper place in the discussion on reserve policy.

Life insurance reserves are "...an amount that together with future premiums will equal future claims."[3] This is a reserve type not considered in this thesis, except that it is defined here to make clear the reason for the writer's failure to discuss it more fully. On the books of industrial or commercial business firms, there is rarely found a reserve account

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1 H. A. Finney, <u>op</u>. <u>cit</u>., p. 346.

2 Charles H. Langer, <u>op</u>. <u>cit</u>., p. 256a

3 Robert Riegel, <u>Insurance Principles and Practices</u> (New York, 1947), p. 161.

resembling a life insurance reserve except in cases where firms provide pensions and the like for their employees. In such cases, allowances for this purpose are carried among the liabilities, and are usually offset by a sinking fund.[1]

No effort will be made to include those bank reserves which are in actuality classifications of assets.[2]

Both life insurance reserves and bank reserves are peculiar to specific types of institutions, life insurance companies and banks respectively, and cannot be treated with justice in a study of this type.

The concept of reserves to be followed here, is the one which has been advanced by Hanson; Stans; and, with only slight modification, by Langer. With full acknowledgement to these authorities, the following concept of "reserves" may be presented. Reserves are reservations of income to provide for future possible losses, reservations of surplus to provide for future possible losses, and reservations of surplus dedicated to capital purposes.[3]

The distinctions between these reserve types are necessarily vague as they overlap. Terminology has ceased to be a problem and the principal consideration has become the ability of the creation and maintenance of such

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1 Roy B. Kester, Advanced Accounting (New York, 4th ed.), p. 191.

2 Additional information on bank reserves may be obtained from other sources. Suggested sources are: W.H. Steiner and E. Shapiro, Money and Banking (New York, 1941); H. Parker Willis and John M. Chapman, The Banking Situation (New York, 1934).

3 Arthur Warren Hanson, op. cit., p. 113; Maurice H. Stans, op. cit. p. 191; Charles H. Langer, op. cit., p. 249.

reserves to affect the periodic determination of net income.[1]

In the following chapters an attempt will be made to point up the influence of reserve policy on accounting practices, the problems posed by methods of treating specific reserves, the effects of reserve policy and accounting technique on other elements, and trends in reserve accounting theory and practice. Opinions will be contrasted at whatever points seem feasible.

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1 Maruice H. Stans, op. cit., p. 191.

CHAPTER II

RESERVE POLICY

Reasons Underlying Reserve Creation

One of the most important questions with which management must deal is whether to retain earnings in the business or to distribute them to the stockholders.[1] Among the factors that will affect the decision are the policies of the directors with respect to capital requirements, and the possibility of future hazards which must be provided for over a long period of time if the business is to be in a position to meet them should they manifest themselves.

Provisions for capital requirements may be made in any combination of three ways. Surplus reserves may be created to retain a sufficient amount of the operating assets in the business to assure adequate capital, stock dividends may be issued to transfer earnings from free surplus to legal capital, or securities may be sold to raise the necessary funds.[2]

Primary concern in this thesis is directed toward the first of these three methods. Growth from earnings could be provided for by merely allowing the surplus account to grow as the operating assets expanded. Some

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1 Harry G. Guthmann and Herbert E. Dougall, Corporate Financial Policy (New York, [1940]), p. 527.

2 Charles W. Gerstenberg, Financial Organization and Management of Business (New York, 1946), pp. 584-5.

consider it preferable, however, to segregate such amounts as are retained for purpose of expansion by setting up a reserve to clearly indicate the determination of management to provide for expansion out of earnings and to keep such amounts unavailable for dividends.[1] This should not imply that surplus is decreased by reserve creation. The mere allocation of surplus does not change its essential character. It is still surplus, but is subject to the restrictions that conditioned its segregation.[2] Opposition to such segregation of surplus is ably presented by Paton. He contends that there is slight justification for the establishment of surplus reserves except in those cases wherein they are established pursuant to contract. In his argument he states that the usual reason for setting up surplus reserves is to hold that part of surplus unavailable for dividends, but that it is an unnecessary step as the directors can decline to declare dividends as easily as they can order a surplus reserve. Furthermore, in those circumstances, in which stockholders are in a position to force the declaration of dividends, subdivisions of earned surplus will not stop them.[3]

Reserves created to provide for the possibility of unforseeable hazards are basically of two types; allowances for hazards which cannot be predicted, but are certain to manifest themselves over a period of time, such as fire, casualty or unforseen tax assessment; and reserves to provide for large unproductive capital expenditures which may have to be made, at some unforseen

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1 Harry G. Guthmann and Herbert E. Dougall, op. cit., pp. 531-2.

2 Robert H. Montgomery, op. cit., p. 373.

3 W. A. Paton, op. cit., p. 1192.

time.[1] It is necessary to substract from gross income arbitrary amounts to express the extent to which any of the above hazards restrict the income of the company. In other words, "...the apparent income of the company must be reduced by an amount that represents the economic valuation of the probability of the occurence of these uncertainties."[2] Despite the difficulty in ascertaining the probabilities that would indicate need for contingency reserves, they should be provided for within the limits of sound managerial judgement. Failure to make allowances for unforseeable losses would be to assume that they were non-existent.

According to Dewing allowances for contingencies are essentially income adjustments.

> The income account of a corporation must be drawn up at a definite date to cover a definite period of time. But the business is like an ever-flowing stream without any critical points unless these are artificially imposed upon it by the accountant. The income account stops at a definite point in the stream, but before this point there were transactions the effect of which on net income will be revealed only after the income account is closed.[3]

If the income period was identical with the life span of a business, allowances would not be necessary; but a business usually outlasts any one of its measured income periods. Consequently each period must carry its share of "... all those charges which are certain and definite only when the whole business has run its life-cycle."[4]

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[1] Arthur Stone Dewing, <u>The Financial Policy of Corporations</u> (New York, 1941), p. 632.

[2] <u>Ibid.</u>, p. 633.

[3] <u>Ibid.</u>, p. 632.

[4] <u>Ibid.</u>, p. 645.

Analysis of Contingency Reserves

It will be recalled that at the end of the preceding chapter a concept of "reserves" was presented. Subsequent to that point, valid reasons underlying reserve creation have been discussed and contingency reserves have been distinguished from reserves for capital purposes. Contingency reserves, reserves for future possible losses, present a highly debatable problem as they may be created from both income and earned surplus.[1] It is therefore necessary to attempt to establish a line of demarcation between operating contingency reserves and earned surplus contingency reserves.

Contingency reserves should provide only for particularized contingent events possessing a reasonable degree of probability.[2] Thus provisions for general-purpose contingency reserves should be made neither from income nor from earned surplus.[3] Those contingency reserves which are created through charges against income should provide only for such contingent events as are inherent in operations. Contingency reserves originating through charges against surplus should provide either for contingent events which have in no sense accrued or for those that should have been provided for in the past through charges to income.[4]

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[1] Charles H. Langer, op. cit., p. 250.

[2] W. A. Paton, op. cit., p. 1036.

[3] George D. Bailey, "The Increasing Significance of the Income Statement", The Journal of Accountancy, LXXV (January, 1948), 16.

[4] W. A. Paton, op. cit., p. 1037; Arthur Stone Dewing, op. cit., p. 637.

Because of the ambiguous nature of contingency reserves, many corporations have resorted to showing them in the balance sheet as a separate group, suspended below liabilities and above net worth as a sort of "indefinite liability".[1] It is better to show those reserves providing for possible loss due to decline in asset values, whether created from income or surplus, as deductions from their related assets; the remainder arising from surplus should be shown in the surplus section; and the remainder arising from operations should be left in the suspense section.[2]

Discontinuance of Reserves

When the reasons that necessitate a contingency reserve no longer exist or when the credits to the reserve have been so excessive that the size of the reserve is unwarranted a new problem is presented if the reserve originated through charges to operations. The earnings will have been understated over a period of years in the amount that the reserve exceeds the sound requirements of the business. The earnings statements cannot be re-created and the only alternative is to transfer the reserve to surplus.[3]

Gerstenberg says that such discontinued allowances should be transferred to surplus and made available for dividends. He adds that such action should be revealed to the stockholders to protect the directors from

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1 Henry Rand Hatfield, Thomas Henry Sanders, and Normal Lee Burton, <u>Accounting Principles and Practices</u> (Boston, [1940]), p. 285.

2 Charles H. Langer, <u>op. cit.</u>, pp. 250ff.

3 Arthur Stone Dewing, <u>op. cit.</u>, p. 693.

suspicion of manipulation.[1]

Dewing suggests that such surplus could be utilized at a later date to absorb unusual losses for which inadequate or no provisions have been made. He opines that it is highly possible that overallowances in some directions are probably offset by underallowances in others.[2]

Improprieties in Reserve Accounting

The methods of utilizing contingency reserves are important. No question arises when a reserve created by charges to surplus is ultimately transferred back to surplus, with the loss being charged against income; but the use of reserves created by charges to operations has, in some cases, merited sharp criticism.[3] Before discussing this problem it is considered appropriate to present brief discussions on "secret reserves" and profit equilization.

"Secret reserves" come into existence when a firm's net assets are understated. To the extent of the understatement a "secret reserve" is said to exist.[4] Such reserves may be either fraudulent, to avoid taxes or deceive interested parties; or paternalistic, based on the conviction that their creation is in the best interests of all parties concerned. Whatever the reasons for creation of such "reserves", if their creation misleads interested parties, or results in evasion of the law they are in flagrant

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1 Charles W. Gerstenberg, op. cit., p. 596.

2 Arthur Stone Dewing, op. cit., p. 693.

3 Maurice H. Stans, op. cit., p. 191.

4 Charles W. Gerstenberg, op. cit., p. 596.

opposition to accounting principles.[1] They are considered here because misuse of true reserve accounts affords excellent opportunity for their creation.[2]

Conservatively managed companies have, in former days, charged certain arbitrary amounts against income in good years to provide a source for profit equalization in poor years. Experience has shown this practice to be open to abuse. Consequently intelligent financial opinion insists that management present the true operating results to the stockholders and "... leave all equalization and averaging to be done by the stockholders."[3]

Though there is seldom adequate justification for "secret reserves" or equalization of profits through the income account[4] either can occur through improper manipulation of reserve accounts. According to Stans, the main question of impropriety in reserve accounting arises:

> (1) When reserve provisions for future contingencies of one kind or another are charged to current income, largely at the whim of management.
> (2) When reserves created by charges to income are used in later years to absorb losses (sometimes without adequate disclosure).
> (3) When items of income are credited directly to reserves which then are used to absorb losses or are ultimately transferred to surplus.[5]

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1 Charles H. Langer, op. cit., p. 281f.

2 Ibid., p. 281.

3 Benjamin Graham and David L. Dodd, Securinty Analysis (New York,1940) p. 502.

4 Reserves for equalization of dividends may be created from earned surplus. W. A. Paton, op. cit., p. 1039. George D. Bailey, "Special Items Arising Out of the War," Contemporary Accounting, ed. Thomas W. Leland (New York, 1945), Chap. xi, p. 9.

5 Maurice H. Stans, op. cit., p. 192.

Under these three practices reserves could be created from income in one year and returned to income in the next, thus tending to equalize profits; reserves created from income in one year could be transferred to surplus in another thus effectively understating income; and "secret reserves" could result when reserves created for one purpose are used for another, or income is credited to a reserve.[1]

Auditor's Responsibility With Respect to Reserves

An auditor, in the process of analyzing reserve accounts, should assure himself of their reasonableness and adequacy for the purposes for which they were created. He should be certain that there have been no inconsistencies in their use that in any manner violates "generally accepted accounting principles".[2] He should not endorse the balance sheet if he feels that unnecessary allocations have been made or that additional allocations should be made. He should insist on revision in keeping with his findings before endorsing the statement.[3]

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[1] *Ibid.*

[2] Samuel J. Broad, "Trends in Auditing and Reporting," *Contemporary Accounting*. Ed. Thomas W. Leland (New York, 1945), Chap. xi, p. 9.

[3] Robert H. Montgomery, *op. cit.*, p. 373.

CHAPTER III

SPECIFIC RESERVES: POLICY AND TREATMENT

Contingency Reserves - Operating

Reserve for contingent fire loss.- There are several contingencies likely to occur against which it is impossible or impractical to insure. If these contingencies, in the opinion of management, merit provisions against the possibility of their occurrence, reserves may be established to provide for them. One such reserve is the reserve for contingent fire loss. Although the fire hazard may be fully covered it may be considered advisable to establish a reserve to provide for losses due to penalties for breach of contract or loss of revenue occasioned by fire. In other cases wherein a firm maintains its physical properties in small, separate, and relatively inexpensive units, it may also be economical to resort to self-insurance.[1]

Such a plan is not to be confused with passive recognition of risk. It is a positive plan to provide for possible future losses. Though it may be applied under varying circumstances it should not be attempted in situations which do not have the requisites for adequate distribution of risk.[2]

If management should dictate that all fire insurance be cancelled on a single large plant, and undertake the provision for fire losses through creation of a reserve, such procedure would not constitute self-insurance

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1 Arthur Stone Dewing, op. cit., p. 636.

2 Robert Riegel and Jerome S. Miller, op. cit., p. 29.

but speculation.[1] On the other hand, a chain grocery store with a wide geographical distribution of a large number of units might be successfully insured against fire through adequate credits to a reserve. Where self-insurance can be successfully employed, it constitutes the most inexpensive form of insurance.[2]

The general practice with respect to self-insurance against fire, is to charge current operations and create a reserve for contingent fire loss with an amount which would have constituted the premium if the risk were borne by insurance companies. The charge against operations is pertinent in that "...a company which is justified in carrying its own insurance will under the experience data suffer a future loss."[3]

Paton says that there is no justification for creating a reserve for contingent fire loss through charges to operations. In his opinion he takes the position that a fire is not a recurrent happening and loss occasioned by fire does not accrue over a continuous period but is sustained at one time.[4]

Langer, in defense of the procedure, says that it should be followed to place the firm in question on a basis comparable with that of other firms in the industry which buy their fire protection instead of carrying their own insurance. Furthermore "... When a company is warranted in carrying self-insurance, there is a reasonable expectancy of loss, and

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1 John H. Magee, General Insurance (Chicago, 1947), p. 183.

2 *Ibid.*

3 Charles H. Langer, *op. cit.*, p. 250.

4 W. A. Paton, *op. cit.*, p. 1037.

such loss is properly considered as part of the operating costs."[1]

Dewing in an illustration of an adequate self-insurance plan to provide for fire loss, suggests one in which provisions are initially made from both income and surplus. Under this plan a reserve would be created from a surplus to provide for any loss which might occur in the immediate future. Another reserve would be accumulated through premium-like charges to income. The surplus reserve would be periodically decreased through reversal entries by such amounts as are periodically credited to the operating reserve. Thus the surplus reserve would serve as a "buffer" until such time as the operating reserve is judged adequate to absorb possible losses.[2]

Under no condition should the assets retained in the firm through creation of a reserve for contingent fire loss, be assets which are themselves subject to the fire hazard.[3]

Reserve for obsolescence.- Some assets are discarded before they are worn out because of changed conditions, a major cause of which may be obsolescence. Obsolescence is the gradual or sudden decline in value of an asset due to improved techniques, changed social conditions or legislations.[4] It may be differentiated from supercession in that it may involve decreased productive value of an asset due to the advent of a substitute producing a

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1 Charles H. Langer, op. cit., p. 250.

2 Arthur Stone Dewing, op. cit., p. 637.

3 Ibid., p. 640.

4 George A. MacFarland and Robert D. Ayars, Accounting Fundamentals (New York, 1947), p. 194.

superior product, while supercession may involve decreased productive value due to improved or more economical production obtained through use of a substitute agent.[1]

Gradual obsolescence may be included in the depreciation charge if it is possible to predict it. Sudden obsolescence, however, must be provided for separately. A reserve for sudden obsolescence may be created through a charge to operations. The reserve should be deducted from its related asset.[2]

Contingency Reserves - Earned Surplus

Reserve for decline in inventory values distinguished from allowance for decline in inventory values.- The Treasury Department has ruled from time to time that it is permissible for a firm to value its inventory at cost, or cost or market whichever is lower, for income tax purposes. However, the courts have held, on occasion, that in computation of earned surplus available for dividends inventories should be valued at the lower of cost or market.[3] In cases wherein the inventory cost is higher than the market value of the inventory, and it is necessary to prepare a balance sheet based on the lower of cost or market, the method used will depend upon the underlying theory.

If the decline in market value is to be looked upon as a loss which has already been realized, operations may be charged and a valuation account

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[1] Charles H. Langer, op.cit., p. 251.

[2] George A. MacFarland and Robert D. Ayars, op. cit., p. 194.

[3] Charles H. Langer, op. cit., p. 191.

established in the amount of the decline. The valuation account could be referred to as "allowance for decline in inventory values".[1]

If the decline in market value is viewed as a possible loss not yet realized, surplus may be debited and a reserve created in the amount of the decline. This reserve could be referred to as "reserve for decline in inventory values".[2]

Either the valuation account or the reserve should be deducted from the inventory account in the balance sheet.

Reserve for future decline in inventory values.- After the inventory has been valued at the lower of cost or market, it may be desirable to make provisions for future market declines in inventory values.[3] The assertion has been made that provisions of this kind enable firms to shift profits from one period to another, frequently without disclosure. For this reason the validity and underlying principles of such reserves should be investigated.[4]

In periods of quickly mounting prices the men in charge of business enterprises have been concerned over the large amounts of inventory they have been compelled to carry at increasingly higher costs. They believe it reasonable to expect that the increases in such costs will be offset by sudden and sharp declines. Because of this they argue that the losses which

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1 Roy B. Kester, Advanced Accounting (New York, 4th Ed.), p. 186; Charles H. Langer, op. cit., p. 235.

2 Charles H. Langer, Ibid., p. 234.

3 H. A. Finney, op. cit., p. 341.

4 Maurice H. Stans, op. cit., p. 192.

they will be forced to take with the advent of price declines, have their origins in the periods of increasing prices and should be provided for from income in those periods.[1]

Another argument frequently made in favor of the creation of inventory reserves out of income is that in a period of high price levels any profits "in excess of normal" should not be reported as income as violent shifts of profits may not be unlikely.[2]

Critics of these beliefs maintain that no "objective" evidence is available to support them, as the computations would have to be made "...on the basis of assumptions as to what future price levels will be and what quantities [Inventory] will be on hand if and when a major price decline takes place."[3]

> The bases for such assumptions are so uncertain that any conclusions drawn from them would generally seem to be speculative guresses rather than informed judgements. This affords strong support for those who contend that these reserves are based so much on whim that they should never be reflected in the accounts except as segregations of surplus.[4]

In addition, it is actually normal to have high profits in some years and low profits in others. Reserves should not be created to transfer current profits to future periods because profits are currently high or

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1 A Special Statement by the Research Department: American Institute of Accountants, "Inventory Reserves," The Journal of Accountancy, LXXXIV (September, 1947), pp. 223f.

2 A Special Statement by the Research Department: American Institute of Accountants, op. cit., p. 224.

3 Ibid., p. 224.

4 Ibid.

to satisfy opinions as to what constitutes normal profits.[1]

Even when a reserve for future decline in inventory values is created from earned surplus, there is danger of mistating income through its use. In some cases wherein shrinkage of value has actually occurred, the losses have been charged directly against the reserve with the result that they were never reflected by the income account.[2]

The reserve should arise from earned surplus and be returned intact to surplus when it has served its purpose. The actual loss should be charged to operations when and if it occurs.[3]

Other Earned Surplus Reserves

Reserve for Working Capital.- A reservation of surplus to assure adequate working capital is justified when there has been a relatively permanent expansion of net current assets.[4]

This appropriation of surplus serves notice on all interested parties that the board of directors does not consider that portion of surplus available for dividends. The board may decrease or increase this reserve as changing conditions demand.[5]

Reserve for Plant Expansion.- Another reserve created to enable a firm

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[1] *Ibid.*, p. 225.

[2] Benjamin Graham and David L. Dodd, *op. cit.*, p. 418.

[3] W. A. Paton, *op. cit.*, p. 1035.

[4] Charles H. Langer, *op. cit.*, p. 252.

[5] George A. MacFarland and Robert D. Ayars, *op. cit.*, p. 407.

to meet capital requirements, is the reserve for plant expansion. Such a reserve may be created when it is the desire of directors to provide for expansion of plant facilities out of profits. It may be created at one time or over a series of years through periodic charges to earned surplus.[1] After the assets retained through creation of the reserve have been transformed into plant additions, the reserve may be returned to surplus. It is possible, however, that it may be desireable to return portions of the reserve at intervals, as the firm will be in no better position to declare dividends out of this reserved segment of surplus.[2]

Reserve for Redemption of Bonds.- A reserve for bond redemption may be compulsory or optional, but it is usually compulsory. It should not be confused with a reserve for bond retirement, as the former provides for the redemption of bonds at their maturity while the latter provides for retirement of bonds before maturity.[3] When assets corresponding more or less closely to the reserve are isolated by a fund, the reserve is said to be "specially covered" or "funded".[4]

Provisions of bond indentures may call for periodic credits to a reserve until such time as the reserve shall have reached a stipulated size. The computations may be required to be made on such bases as fixed amounts, specific percentages of outstanding issues, specific percentages of net

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[1] Ibid.

[2] Charles H. Langer, op. cit., p. 256.

[3] Ibid.

[4] Henry Rand Hatfield, Thomas Henry Sanders and Norman Lee Burton, op. cit., p. 285.

profits, or other bases.[1]

The reserve for bond redemption is created out of surplus, and is returned to surplus when the liability to the bondholders has been satisfied.[2]

Special War Reserves

During World War II, several reserves were created for costs or losses which were not directly chargeable against wartime production. The great majority of these were created from net income after taxes as such provisions were neither allowable for income tax purposes, nor as costs of war contracts under government cost accounting rules.

There is little disagreement on the principle that all costs and losses incident to a war should be charged against war-time operations, but the practical application of this principle is difficult. The impossibility of making any reliable estimate of the need for post-war reconversion reserves resulted in their disallowance by the government. To provide for post-war losses growing out of war-time operations and reconversion, government provisions were made by the establishment of the post-war ten per-cent return of excess profits tax and the two year "carry forward" "carry back" provisions of the tax law enabling firms to deduct post-war losses in the future, or, with reason, to carry them back to war-time years.[3]

In 1942, the Committee on Accounting Procedure of the American Institute

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1 Charles H. Langer, op. cit., p. 256.

2 George A. MacFarland and Robert D. Ayars, op. cit., p. 409.

3 Thomas H. Sanders, "Progress in Development of Basic Concepts", Contemporary Accounting, ed. Thomas W. Leland. (New York [1945]), Chap. i., p. 10.

of Accountants, while recognizing that all reserves for transition to peace-time operations should be created out of war-time income, suggested two treatments for special war reserves. It was suggested that charges for those reserves which must be provided in order to conform to "accepted accounting principles", such as accelerated depreciation and deferred maintenance, be deducted before net income is recognized. The second group, consisting of reserves created as a matter of conservative business policy but not determinable in amount, were recommended as extraordinary deductions after arriving at any figure to be described as net income.[1] This practice agrees substantially with the government position as previously stated.

> After the war these reserves were being disposed of in a great variety of ways. Some were being thrown into income in total; some were being carried forward for future use; some were being used to absorb expenses of the transition period not related to war production; some were being returned to income to the extent of the applicable charges; some were being returned to income only to the extent of the net effect of the applicable charges after considering the tax benefits derived therefrom; and some were being closed out to surplus and not to income.[2]

Because of such diverse procedures the Committee on Accounting Procedure recommended that the reserves be used in consideration of net income only to offset the net effect of charges properly applicable to them, and that reported net income should not be distorted by unused or inapplicable portions of the reserves.[3]

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1 Committee on Accounting Procedure, American Institute of Accountants, "Accounting for Special Reserves Arising out of the War", <u>Accounting Research Bulletin</u> No. 13 (January, 1942).

2 George D. Bailey, op. cit., p. 15.

3 <u>Ibid</u>.

CHAPTER IV

GENERAL OBSERVATIONS

Reserves: Case Analysis

An inspection of sixteen balance sheets selected at random from Moody's Manuals reveals gross inconsistencies with respect to reserve treatment. Several of the accounts defy adequate identification and classification.[1] The following accounts, excluding valuation accounts, were discovered.

1. Reserve for Contingencies
2. Current Operating Reserves
3. Insurance Reserves
4. Miscellaneous Reserves
5. Reserve for Impairment of Investments
6. Reserve for Employees Benefits
7. Reserve for Patent Litigation
8. Post-war Adjustment and Contingency Reserve
9. Reserve for Contingencies, etc.
10. Reserve for Losses on Sub-Leases, etc.
11. Reserve for Inventories
12. Reserve for Pension Plan
13. Workmen's Compensation Reserve
14. Wartime Contract Contingency Reserve
15. Preferred Stock Retirement Reserve
16. Injuries and Damages Reserves
17. Appropriated Income
18. Appropriated Surplus
19. Employees Provident Reserve
20. General Reserves
21. Provision for Future Contingencies
22. Reconversion Reserve
23. Reserve for Federal Tax

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[1] Porter, John S. et al. (ed.) Moody's Manual of Investments: Public Utility Securities (New York, 1942), pp. 199, 928; Moody's Manual of Investments, American and Foreign: Railroad Securities (New York, 1942), pp. 14,808; Moody's Manual of Investments, American and Foreign: Industrial Securities (New York, 1947), pp. 674, 1033, 1636, 1650, 2255, 2626, 2713, 2758, 2817, 2841, 2862, 2890.

24. Additional Compensation Reserves
25. Insurance and Casualty Reserve
26. Sinking Fund Reserve
27. Tax and Contingency Reserve
28. Reserve for Deferred Income
29. Contingency and Miscellaneous Reserves
30. Post-war Contingency and Rehabilitation Reserve
31. Annuity Reserve
32. Insurance Award Reserve
33. Other Reserves

Some of these accounts are probably liabilities or possess a major liability content, for example: Reserve for Federal Tax, Reserve for Employees Benefits, Reserve for Pension Plan, Workmen's Compensation Reserve and Reserve for Deferred Income.[1] Others are so general in nature as to be uninformative, either as to their purposes or the methods of their creation: Reserve for Contingencies, Miscellaneous Reserves, General Reserves, Other Future Contingencies, Post-war Adjustment and Contingency Reserve etc. Current Operating Reserves, Appropriated Surplus and Appropriated Income.

In the face of such facts it is difficult to see how statisticians or other statement analysts can, upon analyzing corporate balance sheets, arrive at book value per share or earnings per share with any degree of accuracy.

The balance sheet of the Standard Oil Company (New Jersey) for the year ended 1946 reveals reserves, not including valuation accounts and current liabilities tactfully placed between liabilities and net worth in such a manner that a reader would probably assume them to be liabilities. The reserves total $186,576,134, which figure is more than seven percent of reported assets and equivalent to over eleven percent of reported net worth.[2]

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[1] *Supra*, p. 5.

[2] Price, Waterhouse & Company, "Annual Report for the Year 1946 Standard Oil Company (New Jersey) and Consolidated Companies," p. 21.

This figure represents a decrease of $19,576,307 from the comparative figure for 1945. That segment of the balance sheets containing these accounts is reproduced here.

	1946	1945
Reserve for Possible Losses on Foreign Investments	$105,000,000	$105,000,000
Other Reserves:		
Annuities	22,004,618	10,441,231
Insurance	37,031,874	34,823,294
Replacement of Tankers	----	24,283,442
Wartime and Post-war Contingencies	9,162,441	24,662,441
Miscellaneous	13,377,201	6,942,033

The comparative statements of consolidated net worth for 1945 and 1946 reveal a $21,974,127 decrease in "Reserve for Replacement of Tankers". The balance sheet reserve section reveals a decrease of $24,283,442 in this account.[1]

A special statement is included in the report giving the information that "...uncertainties in the European situation have made it advisable to retain unchanged for the present $105,000,000 Reserve for Possible Losses on Foreign Investments."[2]

The consolidated income statement reveals that $15,500,000 of the 1945 "Reserve for Wartime and Post-war Contingencies" was credited against deductions from income in 1946. It was exhibited as a decrease in income deductions before net income, and resulted in an 8.7% overstatement of the net income figure. The following statements were made with respect to this action.

> These reserves were provided during the war period and include provisions for renegotiation of government contracts, inventory replacements, deferred repairs and maintenance, and other contingencies. The reduction of $15,500,000 in wartime

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1 Ibid., p. 21f.

2 Ibid., p. 15.

> and post-war reserves was restored to income as an offset to costs and other charges incurred in 1946 applicable to the war period and to adjust these reserves for amounts no longer required. Renegotiation proceedings for the year 1944 are now nearing completion, but those for the year 1945 have not progressed to the stage where the results thereof can be determined. It is the opinion of management that the renegotiable profits realized on war contracts for the years 1944 and 1945 were moderate, and that adequate provision had been made for this and other wartime contingencies.[1]

No other reserve adjustments are indicated in the consolidated income statement. It is possible, however, that additional credits to reserves are buried in the income statement figure "Miscellaneous Deductions".[2]

If the net effect of changes in the reserve balances is considered, it is apparent that there has not been complete disclosure of reserve transactions.

Reserves, Dec. 31, 1946		$186,576,134
Reserves, Dec. 31, 1945	$206,152,441	
Explained Decrease	37,474,127	168,678,314
*Net Unexplained Increase		$ 17,897,820
*Consisting of:		
Unexplained Increase		$ 20,207,135
Unexplained Decrease		2,309,315
		$ 17,897,820

Stans presents some interesting cases involving irregular use of reserve accounts. In one case a company used "reserves for possible future inventory adjustment" created from income in 1941, 1942, and 1943 to hold the

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1 *Ibid.*, p. 25.

2 *Ibid.*, p. 22.

reported net income at the uniform level for the preceding five years. In 1944 and 1945, when earnings had returned to prewar levels no reservations of income were made. In 1946 when earnings rose to exceed the prewar level, the reserves were increased and relabeled "reserve for contingencies." A certain statistical service now assures prospective investors that credits from reserves may be used to modify future decline in net income.[1]

Differences in reserve accounting methods and policy distort comparisons between similar firms within an industry. The significance with respect to apparent earnings and market value of stock is illustrated in a comparison by Graham and Dodd of different methods in treatments of "inventory reserves" by two rubber companies.

In the period 1925 through 1927 rubber prices were subject to wide fluctuations. In these three years Goodyear Tire and Rubber Company charged $11,500,000 against operations to provide a reserve for market decline in value of raw material inventory. Until 1930 half of this amount remained in the reserve account. During the same time the United States Rubber Company charged more than $20,000,000 against operations for the same purpose and all of its "inventory reserves" were absorbed by actual losses. In annual statements to the stockholders, these deductions from income were presented as special adjustments of surplus.

As a result of such divergent methods of reporting annual net income, average earnings per share for the three year period as presented by statistical manuals was $8.91 for U. S. Rubber and $7.42 for Goodyear. This was reflected by average market prices per share of $62.00 for U. S. Rubber

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[1] Maurice H. Stans, _op. cit._, p. 192.

and $40.00 for Goodyear.

If no adjustments for changes in inventory values had been made, the reported per share earnings would have been $8.91 for U. S. Rubber and $12.17 for Goodyear. If, in both cases, inventory adjustments had been shown as deductions from income, earnings would have been $0.49 for U. S. Rubber and $7.42 for Goodyear. If no reserves had been created and inventory losses had been charged to the years in which they occurred, earnings would have been $0.49 for U. S. Rubber and $9.73 for Goodyear.[1]

Regulatory Agencies

In 1933, the New York Stock Exchange adopted the requirement that all financial statements accompanying applications, for listing of a company's stock on the exchange, would have to be certified by certified public accountants. It was also required that future annual statements should also be audited. The requirement for initial listing has been maintained, but the stock exchanges have paid little attention to statements published after the listing has been approved. In some cases, however, the New York Stock Exchange has required corporations to clarify statements under threat of removal of their securities from trade at the exchange.[2]

The Securities Actoof 1933 requires every corporation or foreign government offering securities for sale in inter-state commerce to register them with the Securities Exchange Commission. It imposes liability on certain persons if the registration statement filed with the Commission

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1 Benjamin Graham and David L. Dodd, op. cit., pp. 418-20.

2 Richard N. Owens, Owens on Business Organization and Combination (New York, 1941), p. 202f.

gives untrue or incomplete statements. The liable parties include every person who signed the registration statement, every director or partner of the issuing company, every accountant, engineer, or appraiser who, with his consent, is named as having prepared or certified any part of the registration statement. The liability extends in favor of purchasers of the securities, if they purchase them without knowledge of the misrepresentations.[1]

Reserves and Federal Taxation

As a general rule reserves set up to provide for future possible liabilities are not deductible for income tax purposes. This is not to infer, however, that the creation of reserves from current income is not prudent business and accounting practice. The underlying principle is that the income tax law is concerned only with realized losses and expenses. Since the amount of a contingent liability cannot be predicted with any degree of accuracy, there is no assurance that the amount of the reserve will accurately reflect the actual future liability. Unless the reserve is expressly authorized by the "Code", no deduction is permitted for a loss or expense which has not yet been incurred.[2]

Examples of non-deductible reserves for contingent fire loss, reserves for collection expense, reserves for future possible repayments, reserves for future commissions to salesmen, and reserves for fluctuation in the

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[1] Elvin F. Donaldson, Business Organization and Procedure (New York, 1938), pp. 312f.

[2] Research Institute of America, Federal Tax Coordinator (New York, 1946), Vol. I, p. 14,702.

market value of securities. In addition no deductions may be taken for reserves required by state law or contract.[1]

If a taxpayer sets up a non-deductible reserve on his books, adjustments must be made for income tax purposes. The reserves must be returned to taxable income for the year in which they are set aside. After this, the amounts which are withdrawn from the reserve to pay liabilities as they are incurred, may be deducted for tax purposes, so long as the deductions are otherwise allowable. Any unexpended balance in the reserve account may be transferred to surplus.

If a reserve is erroneously allowed by the Tax Commissioner, a loss or liability which is paid out of the reserve is not allowable. The Commissioner is then not in a position to increase the income of a later year in the amount of the deduction erroneously permitted. He may, however, assess additional tax for the year in which the deduction was allowed, unless the statute of limitations has barred such action.[2]

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[1] Ibid., p. 14,703.

[2] Ibid., p. 14,705.

CHAPTER V

SUMMARY AND CONCLUSIONS

Accounting is an art, not a science. It cannot be adequately defined but may be identified by its major functions; to analyze, summarize, and interpret financial records. The accountant is handicapped in his work as he must recognize intangible and immeasurable business factors and translate them into terms of the monetary unit. The vocabulary which he uses in this process is frequently indefinite and applied in too many ways to lend itself to stable expression. Even the principles upon which he attempts to base his endeavors are constantly changing and, at times, ambiguous.

With such a background as this it is not surprising that a term like "reserves" is inconsistently utilized by businessmen, accountants, or other analysts of corporate financial statements. The resultant confusion from varied interpretations and applications of this term, tends to contribute to an undermining of the worth of financial reports.

Attempts to classify "reserves" have centered around their methods of derivation, balance sheet presentation, and underlying theory. In the most indiscriminate general usage, they include valuation accounts, accrued liabilities, allocations of income, allocations of earned surplus, and surplus arising through increased valuation of assets. In attempts to limit the use of the term "reserves", authorities suggest the following divergent groupings:

1. Valuation accounts, accrued estimated liabilities, allocations of income to provide for contingencies, and allocations of earned surplus.

2. Allocations of income to provide for contingencies and allocations of earned surplus.
3. Allocations of income to provide for contingencies and allocations of earned surplus to provide for contingencies.
4. Allocations of earned surplus only.

For purposes of this thesis, the meaning of "reserves" was limited to the second of these. By holding this concept constant, it became possible to analyze, interpret, and compare reserve treatments.

Reserve creation results either from the policies of directors with respect to capital requirements and the recognition of future possible losses, or requirements imposed upon firms by regulatory agencies and contract. The first items are provided for within the limits of managerial judgement.

It is difficult to segregate those provisions for future possible loss, (contingency reserves), which may be properly created out of current income. The best available procedure is to create out of income only those reserves which arise through recognition of losses or hazards which are inherent in operations.

Examples of contingency reserves which may be created from income are reserves for contingent fire loss and reserves for obsolescence. Both of these, according to certain theorists, are created in recognition of hazards which are inherent in operations. The creation of such reserves out of income is not, however, without opposition.

Contingency reserves which should only be created through charges to surplus include reserves for decline in inventory values and reserves for future declines in inventory values. Corporate directors in some cases have undertaken to take exception to this rule, as they feel that inventory losses may, at certain times, be inherent in operations, and that profits "in excess of normal" should not be reported when there is serious danger of future loss.

Reserves dedicated to capital purposes include such items as reserves for working capital, reserves for plant expansion, and reserves for bond redemption. They are not created in contemplation of future possible losses and serve only to meet specific capital requirements. Because of this, they are only created from earned surplus.

Special war reserves have been used with lack of reconciliation between accounting theory and practice. The Committee on Procedure of the American Institute of Accountants has attempted to establish basic principles concerning them, but their bulletins have too frequently been either misunderstood or ignored on this subject. At present the treatments of these accounts are so lacking in uniformity, that they constitute a major reserve problem.

The principal improprieties in reserve accounting arise when reserves are created or used in such a manner as will obscure a fair presentation of operating results. Through manipulation of reserve accounts, secret reserves may be created and reported net income may be varied at the whim of management. For this reason, so-called equalization reserves, though favored by management in certain cases, are generally considered as being in opposition to accounting principles by accountants.

In one observation it was found that a company, through use of equalization reserves, had effectively circumvented the income account, and through an intermediary reserve account transferred amounts indirectly to surplus. In another, it was demonstrated that improper reserve use might not only affect apparent earnings, but mihgt also contribute to those influences which decide values placed on securities by the market.

As a general rule, charges against income to provide for reserves are not deductible for Federal income tax purposes. This is true even when the creation of a certain reserve may be required by state law or regulatory agencies.

Both the Securities Exchange Commission and the New York Stock Exchange, have attempted to regulate the preparation of financial statements by requiring them to meet certain standards. The only corporations subject to such regulation, however, are those engaged in inter-state commerce, and those that have securities listed on the Exchange. In either case, the regulations are difficult to enforce.

When the points of view of leading authorities who have made contributions to literature concerned with reserves have been taken into account, one reaches the conclusion that this area of statement presentation is one in which the reader is likely to experience considerable confusion. One also reaches the conclusion that there are numerous methods by which accountants and business executives seek to eclipse portions of the profits of corporations for whose fiscal affairs they are responsible. Another inescapable conclusion is that the whole family of contingency reserves make up a body of accounts employed by accountants and corporate managements in attempts to assign monetary value to estimates of what might happen in the future, as well as to measure probable, or possible losses lurking in the asset structure of the business firm. It is also concluded that even those most learned in the fields of accounting and finance cannot be sure that identical descriptive titles of reserve accounts as used by one accountant mean the same as when used by another, nor can one be sure that when the same accountant uses a reserve title it is always intended to convey the same meaning.

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